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**MINUTES OF  
MONETARY POLICY  
COMMITTEE MEETING  
5 and 6 April 2006**

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These are the minutes of the Monetary Policy Committee meeting held on 5 and 6 April 2006.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2006/mpc0604.pdf>

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting held on 3 and 4 May will be published on 17 May 2006.



## **MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 5-6 APRIL 2006**

1 At the start of the meeting, the Committee noted a letter from the Chancellor (attached as an annex) setting out the remit for the Committee over the following year, in accordance with Section 12 of the Bank of England Act. Before turning to its immediate policy decision, the Committee then discussed developments in financial markets; the international economy; money, credit, demand and output; and supply, costs and prices.

### **Financial markets**

2 Short-term market interest rates had risen slightly since the March MPC meeting. Six-month sterling interest rates were slightly higher, by around 2 basis points, dollar rates had risen by around 4 basis points and euro rates by around 18 basis points. At least one further rise of 25 basis points in official interest rates in 2006 had been priced in for the United States and two rises for the euro area. In the United Kingdom, the interest rate curve remained broadly flat for 2006 with some possibility priced in of a 25 basis point increase during 2007. The Reuters survey of economists revealed a slightly different view, with the distribution of expectations for the end of 2006 still slightly skewed towards the possibility of an interest rate reduction. But the average of the expectations reported in the survey had risen over the month.

3 Longer-term rates had also risen since the March MPC meeting, with nominal and real 10-year forward rates around 10-15 basis points higher in the United Kingdom, 10-20 basis points higher in the United States and around 25 basis points higher in the euro area. Since their trough in mid-January, real long-term forward rates had risen by around 40 basis points in the United Kingdom and the United States and by around 60 basis points in the euro area, although their levels remained historically low. The Committee discussed several possible explanations for the recent rises. Asset prices may have been generally high and bond yields low, in response to increased liquidity generated by accommodative monetary policies in the major economies. As short-term policy rates in the United States and euro area had been increased, and the possibility of increasing official rates had been signaled in Japan, the withdrawal of liquidity might have contributed to a reduction in bond prices. A second possible explanation was that low yields had simply reflected the balance of global savings and investment decisions: a pickup in real investment in the major economies would also have caused

bond yields to rise. A third possible explanation was that markets were uncertain about what the neutral official rate of interest would be in steady state and had been changing their views in response to policy makers' actions and comments. Overall, it was too early to conclude that the recent rise in long-term interest rates was likely to be the start of a larger market correction.

4 It was noted that despite the rise in the level of government bond yields, credit spreads had not widened. Indeed, the spreads on emerging market and non-investment grade corporate bonds remained close to recent historical lows.

5 Alongside the increase in bond yields, the strong growth in equity prices was puzzling at first sight. Since the publication of the February *Inflation Report*, UK and European indices had risen by around 4% and the S&P 500 by a little less. Compared with a year earlier, the FTSE All-Share index had risen by around 20%. It was possible that evidence of continued strong growth in the global economy had led market participants to be more confident about the prospects for corporate profits and hence equity prices. Rising equity prices might also have reflected a potentially transient impact from recent high levels of merger and acquisition activity and speculation about company buy-outs. Whatever the cause of the strong rise in equity prices, the implied price-to-earnings ratio was only a little above its average since 1990.

6 The sterling effective exchange rate index (ERI) had fallen by nearly 2% since the February *Inflation Report* and by just over 1% since the March MPC meeting: sterling had depreciated against both the euro and the dollar. It was possible that the prospect of further rises in official interest rates in the United States and the euro area, compared with market expectations of a flat interest rate curve in the United Kingdom, had made sterling less attractive for short-term capital flows. Looking over a longer period, the trend in the ERI since early 2004 had been gently downwards and broadly consistent with interest differentials.

7 The Committee noted that implied volatilities of sterling's bilateral exchange rates against the dollar and the euro, as estimated from options prices, remained at three-year lows. Given press and market commentary about global imbalances and the consequent potential for a significant change in the pattern of exchange rates, the low level of exchange rate volatility priced in the market was something of a puzzle, especially since the bilateral exchange rates had been much more volatile than the sterling ERI.

## **The international economy**

8 Most activity indicators and surveys in the euro area had continued to be strong in Q1, notably the German IFO survey of business conditions in March which had recorded its highest level since 1991 and the European Commission survey of industrial confidence for which the quarterly average had reached its highest level since early 2001. German export performance had remained strong through the past two years although, over the past decade, an increasing proportion of German exports had been based on imported components, so gross output had probably been rising faster than value added. Given the strength of the surveys and other monthly data, Q1 GDP growth in the euro area was likely to have been somewhat stronger than expected at the time of the February *Inflation Report*.

9 Household consumption growth in the euro area had remained below its historical average, although with significant variations across countries. In the past, output recoveries in the euro area had not typically been consumption-led and recent data appeared to be consistent with that experience. While downside risks to consumption remained, it was possible that the pickup in output growth would help to boost employment and hence consumption growth in 2006.

10 In the United States, recent data had been consistent with the view that there had been some recovery following temporary weakness in Q4 2005, and growth in the first quarter of 2006 appeared likely to be in line with the February *Inflation Report* forecast. Manufacturing and non-manufacturing indices from the Institute for Supply Management, employment and consumption growth, had all been reasonably strong. Capacity utilisation had been slightly above its post-1990 average and the unemployment rate was historically low, average hourly earnings growth had been picking up and headline consumer price inflation was 3.6% in February. However, there were some signs that the US housing market was slowing and that might be followed by a moderation in consumption growth in due course, although the magnitude and the timing of such a link were uncertain. Furthermore, to the extent that the impact of increases in policy rates had previously been attenuated by lower long-term rates, the recent increases in the latter could lead to further restraint on demand growth. Consistent with this uncertainty, implied volatilities for interest rates around five years forward, calculated from options prices, were significantly higher for the United States than for the United Kingdom or euro area.

11 Recent activity indicators for Japan, such as the Tankan survey, suggested that the economic recovery there continued to be firmly based and positive CPI inflation seemed likely to continue. The rest of Asia had continued to record strong growth, and oil-producing countries had been growing fast.

12 Brent oil prices had risen by over 10% on the month although the level of the dollar price had remained broadly within the range seen since August 2005. The rise on the month had seemed to reflect uncertainties about future supplies from Iran and Nigeria, despite the continuing relatively high levels of crude oil stocks in the United States. Export price inflation in the United Kingdom's major trading partners had unexpectedly picked up in Q4 2005.

### **Money, credit, demand and output**

13 M4 had continued to grow strongly; by over 12% in the year to February 2006. Excluding the volatile 'Other Financial Corporations' component, growth had been around 9%. With nominal domestic demand growth having slipped below 4%, the velocity of broad money had continued to trend downwards, as it had for most of the previous 25 years. The recent growth of M4 – and the observed decline in velocity – was perhaps faster than could be accounted for by its normal determinants.

14 The Budget had contained little change in plans for future Government expenditure and tax rates compared with the *Pre-Budget Report* published the previous autumn.

15 In the March release of the Quarterly National Accounts data, GDP growth in Q4 2005 had been unrevised and revisions to previous quarters had generally been small. Services growth had been revised up a little but remained somewhat weaker than indicated by other business surveys. Much of this was due to the distribution component of services output which had been flat in the first half of 2005, had then picked up in the second half of the year, but had declined more recently. Although the initial data on distribution output were very often substantially revised, their pattern seemed consistent with other indicators of activity in the distribution sector.

16 Consumption growth in the fourth quarter had been revised up by 0.1 percentage points to 0.8%, accentuating the picture of a sharp rebound in consumption since the standstill at the beginning of 2005. Although post-tax labour income had been relatively strong in Q4, weak property income growth meant that the savings ratio had declined. Government consumption and net trade had been reasonably strong. Investment, although upwardly revised, had fallen slightly on the quarter. Overall the expenditure data for the fourth quarter had been stronger than the output data – with the difference accounted for by de-stocking (including a large contribution from the alignment adjustment to make the Quarterly National Accounts consistent).

17 In contrast to the Q4 data, the available indicators of output growth for the first quarter of 2006 had been stronger than indicators of expenditure growth, notwithstanding the slightly weaker than expected Index of Production for February and the strong, but slightly lower, level of the CIPS survey balances for March. Although retail sales had risen by 0.5% in February, this had followed a much larger fall in January. Information gathered by the Bank's regional Agents had suggested that retail sales in March had remained subdued. The GfK consumer confidence survey had also weakened.

18 House prices continued to rise quite strongly in the first quarter with the mortgage lenders' house price indices rising by an average of 2%. Activity indicators generally showed little evidence of any imminent slowdown, although the number of mortgage approvals had been slightly down in February and there had been a small decrease in the number of new buyer enquiries in the preview of the RICS survey for March.

19 The differing profiles of output and expenditure might have been a genuine reflection of the timing of temporarily high consumption in Q4 perhaps causing a reduction in stockbuilding, followed by an over-optimistic and supply response. Perhaps the 2005 Q4 data should be treated as erratic. Averaging the data over the past two quarters would suggest that output and consumption had been growing at around trend over the period.

### **Supply, costs and prices**

20 There had not been much news on costs and prices since the March MPC meeting. Employment had fallen by around seven thousand on the Labour Force Survey measure in the three months to January but the Workforce Jobs measure had been more buoyant in Q4. Over the previous year the

two measures had moved broadly in line and were consistent with a modest loosening of labour market pressure: unemployment had continued to edge up and the stock of job vacancies had declined. It was possible that some of the increase in unemployment was structural, rather than cyclical, following the rise in energy prices.

21 Productivity growth – which had been unusually low in 2005 – had recently increased, reflecting both the pickup in GDP growth and the weakening of employment growth. Regular pay growth had edged up in January but had been more than offset by a negative contribution from lower bonus payments. The wage settlement data so far available in 2006 on a matched sample basis, appeared to be somewhat lower than a year earlier, although this particularly reflected a few settlements in the services sector.

22 Manufacturing input and output price inflation had been little changed on the month while both the CIPS manufacturing survey and the CBI *Monthly Industrial Trends Survey* pointed to some strengthening of output price pressures.

23 Annual CPI inflation was 2.0% in February. Wholesale gas prices had come down from recent peaks but the average price for 2006, based on futures markets, would be some 50% higher than in 2005.

24 Recent surveys of the general public – including the Bank of England/NOP and the Citigroup/YouGov surveys – had appeared to show a noticeable increase in inflation expectations. That might have reflected recent announcements of higher gas and electricity prices, but the data would need to be monitored carefully.

25 Although there was little evidence of rising nominal wage pressures, the annual growth rate of the average real product wage – that is the real cost faced by the employer – had risen a little since the start of 2005, while the growth of the average real consumption wage earned by employees had fallen a little. The rise in real product wage growth could have been evidence of some resistance to the required fall in real consumption wage growth in the face of higher energy prices, although this could also reflect measurement issues: the higher costs facing employers would, in part, reflect any one-off payments to offset pension fund deficits, but they would not affect the marginal cost of employing labour.

## The immediate policy decision

26 Interest rates had risen internationally and at all maturities since the March MPC meeting. But over the same period equity prices had risen strongly, house price inflation had remained at a quarterly rate of around 2% and the exchange rate had fallen by over 1%. Taking these developments together, the Committee agreed that asset prices were likely to be supportive for UK demand growth going forward. Recent monetary tightening in the major economies had not caused any disturbance in financial markets.

27 The international economy also continued to be relatively strong. In the euro area, indicators had pointed to growth at or above trend in the near term. In the United States, economic growth continued to be robust, although there appeared to be some downside risks to activity should consumption growth slow with the housing market. Overall, UK trade-weighted world import growth had been at least as strong as projected in the February *Inflation Report* and global demand growth looked set to remain robust in 2006. The Bank's regional Agents had suggested that exporters were optimistic about their immediate prospects.

28 In the United Kingdom, abstracting from erratic quarterly movements, it seemed that both GDP and consumption had grown around trend in the past couple of quarters.

29 Recent data could reflect the start of a re-balancing of the economy away from domestic consumption and towards other components of expenditure, particularly net exports. That would be encouraged by recent movements in relative prices, including higher energy prices, which would depress real personal disposable income, and the weakening of the effective exchange rate, which would support export demand. Such a rebalancing would have little impact on domestic inflationary pressure, despite slower consumption growth.

30 The latest labour market data were consistent with some modest loosening: employment had grown over the previous year but not sufficiently fast to prevent a small rise in unemployment. Regular pay growth had edged up in January but had been more than offset by a negative contribution from bonus payments. And wage settlements in January and February appeared to be showing no signs of any increase on a year earlier. Although producer and consumer price inflation were little

changed on the month, inflation expectations had picked up in recent surveys and this would need to be monitored carefully.

31 Output growth since mid-2004 appeared to have been a little less than estimates of the rate of growth of potential output but it was very difficult to know whether the level of output was materially below potential. For some members, this period of below-trend growth, together with evidence from business surveys and an easing of labour market conditions, clearly left the economy with some spare capacity. For others, given that the margin of spare capacity in 2004 and the growth of potential supply since then were unobservable, it was difficult to draw strong conclusions about the current margin of spare capacity. Against a background of sharp increases in energy prices, there were risks of overestimating supply capacity.

32 Overall, the Committee agreed that there had been little news on the month. For most Committee members the data suggested that recent output growth had continued to grow at or around the trend rate, although for some there remained a small downside risk to the near-term outlook. Inflation was likely to remain close to target with some upside risks in the near term related to recent increases in energy prices. In the light of those considerations it was appropriate to leave the repo rate unchanged this month.

33 For one member, there remained a case for the repo rate to be 25 basis points lower. The data continued to suggest that there was a degree of spare capacity in the economy, particularly in the labour market. Permanent income would be negatively impacted by higher energy prices and the rising effective tax rate and so consumption growth was unlikely to pick up. There was no evidence of any second round price impact from higher energy prices and hence inflation was likely to fall modestly below the target as the first round effects began to drop out of the annual rate of change.

34 The Governor invited the Committee to vote on the proposition that the repo rate should be maintained at 4.5%. Seven members of the Committee (the Governor, Rachel Lomax, John Gieve, Kate Barker, Charles Bean, Paul Tucker and David Walton) voted in favour. Stephen Nickell voted against, preferring a reduction in the repo rate of 25 basis points.

35 Finally, the Governor expressed his appreciation for Richard Lambert's contribution as a member of the Committee.

36 The following members of the Committee were present:

Mervyn King, Governor

Rachel Lomax, Deputy Governor responsible for monetary policy

John Gieve, Deputy Governor responsible for financial stability

Kate Barker

Charles Bean

Stephen Nickell

Paul Tucker

David Walton

Jon Cunliffe was present as the Treasury representative.